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In The
Supreme Court of the United States
October Term, 1993

U.S. BANCORP MORTGAGE COMPANY,
Petitioner,
v.
BONNER MALL PARTNERSHIP,
Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

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AMICUS CURIAE BRIEF OF CHARLES W. ADAMS IN SUPPORT OF NEITHER PARTY

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Letters from the parties consenting to the filing of this amicus curiae brief have been filed with the Clerk.

INTEREST OF AMICUS CURIAE

I am not representing a client, and the views expressed in this brief are my own. I have no monetary interest in this or any other bankruptcy case. Aside from wishing to assist the Court, my interests in this case are entirely academic. I am a Professor of Law at The University of Tulsa College of Law, where I have taught courses in creditors' rights and bankruptcy. I am the author of *An Economic Justification for Corporate Reorganizations*, 20 Hofstra L. Rev. 117 (1991). I had completed a forthcoming article dealing with capital contributions in Chapter 11 reorganizations when the Court granted *certiorari* in this case.

SUMMARY OF ARGUMENT

This brief supports the Respondent's position that the Court should recognize a new capital exception to the absolute priority rule. However, it is opposed to the Respondent's plan of reorganization because the plan does not appear to provide an adequate equity cushion in the debtor's capital structure following reorganization. Consequently, this brief is aligned with neither party.

The purpose of a Chapter 11 reorganization is to repair an insolvent company's dysfunctional capital structure. It should not matter whether the new capital

that an insolvent company needs for a successful reorganization comes from its creditors, outside investors, or its former owners. What is critical to the reorganization is the substance (i.e., the form and amount) of the new capital contribution, rather than its source. In addition to recognizing the new capital exception, the Court should clarify the size of the capital contribution that is required.

The prevailing standard from *Case v. Los Angeles Lumber Co.*, 308 U.S. 106, 121-22 (1939), is unworkable. While superficially plausible, the *Los Angeles Lumber* standard turns out on closer analysis to be merely a tautology. It should be replaced by a standard requiring an investment of sufficient new capital that the reorganized company will have a capital structure solid enough to withstand future adversity without failing again. This standard derives from the "feasibility requirement" in 11 U.S.C. § 1129(a)(11). Section 1129(a)(11) prescribes that a bankruptcy court shall confirm a reorganization plan only if it "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor."

ARGUMENT

I. The Purpose of Chapter 11

A bankruptcy reorganization is a process for restoring financial health to an insolvent business through an adjustment of its capital structure. Generally, the adjustment involves the discharge of some debt and the infusion of new capital from either outside investors, the company's creditors, or its owners.

A business normally is financed partly through equity and partly through debt. Some equity is essential in a company's capital structure to capture the residual interest in its future earnings. Most companies also have substantial levels of debt financing. Besides offering a tax benefit, debt in a company's capital structure provides leverage to owners, enabling them to earn a higher expected return, though at greater risk.

Excessive debt, however, produces a risk of default and a possible conflict of interest between the company's owners and its creditors. A conflict of interest may arise because the owners are entitled to the profits if the business succeeds, while the maximum return for the creditors is the stated rate of interest. In a company where most of the capital structure is debt with its owners having only a small amount of equity invested, the owners will have an incentive for excessive risk-taking. The owners have everything to gain if a risky venture succeeds, and nothing but their limited equity to lose if it fails. The creditors, on the other hand, will continue to earn only their fixed interest payments if the venture is successful, while they risk nonpayment of the loan principal if it fails.

The risk of default and the potential conflict of interest associated with a leveraged capital structure are normally held in check by the maintenance of a suitable equity cushion. An equity cushion represents the owners' stake in the enterprise, and the presence of a substantial equity cushion insures that most of the risk is borne by the owners, rather than the creditors.

An insolvent company has a pathological capital structure. Because liabilities already exceed asset value, an insolvent company's owners have nothing more to lose from further operating losses. Rather than maximizing the expected return from operations, the owners' primary concern will be to have the business earn a sufficient return so that it can become solvent again. Because owners of an insolvent company bear none of the downside risk, they will favor risky ventures with the potential for large gains over others with more predictable, but smaller, gains. Until the business achieves solvency, moderate gains will benefit only the creditors and not the owners.

Unfortunately, both the creditors and owners of an insolvent business lack incentives for maximizing its long term interests. Insolvency generates destructive conflicts of interests between the company's owners and creditors, with the owners seeking to have the business take excessive risks and the creditors trying to collect as much on their claims as they can through seizure of the company's assets. A company cannot operate effectively until these conflicts are resolved. It is the resolution of these conflicts through the restoration of a sound capital structure that is the fundamental purpose of the bankruptcy reorganization process. Charles W. Adams, *An Economic Justification for Corporate Reorganizations*, 20 Hofstra L. Rev. 117, 117-38, 157-58 (1991).

II. The Source of the Capital Contribution

There are only three potential sources of capital for an equity cushion in a reorganized company: the company's creditors, outside investors, and its existing owners.

First, the company's creditors may provide the necessary capital through a conversion of some of their debt into equity. A satisfactory capital structure can be restored by discharging part of the debt (the portion above the company's going concern value) converting some debt to equity to create an equity cushion, and allowing the remainder to continue as debt in the reorganized company. A major disadvantage of this approach to reorganization is that it may not be feasible for some creditors to become equity owners of the reorganized business. Banks, for example, are a major source of debt financing, and the Glass-Steagall Act, 12 U.S.C. § 24 (Seventh), imposes significant restrictions on their ownership of common stock. *See* Regulation Y, 12 C.F.R. § 225.22(c)(1)(i) (bank holding companies may hold voting securities that are acquired in the ordinary course of collecting a debt if they are divested within two years of acquisition); Frederick K. Beutel & Milton R. Schroeder, *Bank Officer's Handbook of Commercial Banking Law* §§ 4-30, 5-30 (5th ed. 1982).

Outside investors are an alternative source of new capital for the equity cushion. Again, the portion of the debt above the company's going concern value will have to be discharged with the remainder continuing as debt in the reorganized company. In return for their new capital contributions, the outside investors receive ownership of the reorganized company, and their ownership interests constitute the equity cushion. A major disadvantage to this approach is that it may be difficult to find outside investors willing to contribute capital to an insolvent company.

INTEREST OF THE AMICI CURIAE

The California Bankers Association ("CBA") and the American Bankers Association ("ABA") jointly file this brief as *amici curiae* in support of Petitioner U.S. Bancorp Mortgage Company.*

Amici are associations that represent banks in California and across the country. The CBA is the principal trade association for the lending industry in California. It represents virtually all of the commercial banks and trust companies in California. The ABA is the principal trade association for the commercial banking industry in the United States. It represents commercial banks of all types and sizes in each of the fifty states and the District of Columbia. Together, ABA member banks represent approximately ninety percent of the assets of the nation's banks.

This appeal is of vital interest to the CBA, the ABA and their member banks. This Court's decision will have wide-ranging legal and practical consequences for virtually every lender in the United States. The determination whether the owners of businesses in chapter 11 may retain their equity interests by contributing "new value," but without paying objecting creditors in full, will affect not only lenders' litigation and negotiation strategies in bankruptcy cases but their actions in making new loans and working out troubled loans as well.

This brief is filed pursuant to Rule 37.3 of the Rules of this Court. The parties have consented to the filing of this brief. Their letters of consent have been filed with the Clerk of this Court.
* See Addendum 1

SUMMARY OF ARGUMENT

The new value rule[1] has never been more than a theoretical construct. The rule originated in a Supreme Court *dictum* that pre-dated the current bankruptcy code[2] by almost fifty years and

[1] Although there is some controversy over the proper terminology, *amici* will simply refer to the concept as the "new value rule."

[2] 11 U.S.C. §§ 101 *et seq.*, as amended (hereinafter "Code"). All "Section" references herein are to the Code unless specified otherwise.

was virtually unused under pre-Code law.[3] To the extent that there was a new value rule under the Act, its purpose was to protect majority creditors from the harsh results that sometimes attended the absolute priority rule, namely allowing even a single creditor to block confirmation of a plan accepted by the majority.

With the enactment of the Code, any new value rule that even theoretically existed under the Act was abolished.[4] The Code has complex rules for allocating reorganization value, requiring that each class of unsecured creditors receive "fair and equitable" treatment in accordance with the absolute priority rule (unqualified by any new value rule); alternatively, a class can consent to alternative treatment by specific majority vote, and thereby bind dissenters. The Code thus eliminates the intra-creditor conflict that gave rise to the new value rule. Under the Act, the new value rule was used as a weapon by majority creditors against dissenters; under the Code, its only use is by owners against majority creditors.

The new value rule upsets the Code's careful balance among secured creditors, senior and junior unsecured creditors and owners, which is apparent throughout chapter 11. The new value rule also undermines an important philosophic premise of the Code, which is to substitute negotiation and class voting for judicial resolution of competing interests. The Code does not give courts the power to change the rules on general equitable grounds.

As a matter of policy, the new value rule is highly costly and disruptive. Since virtually all debtors are insolvent, the costs of bankruptcy fall almost entirely on creditors. The rule delays resolution of bankruptcy cases (by giving owners an incentive for strategic delay), gives additional leverage to owners, increases transaction costs (by substituting a vague standard for the specific

[3] Act of July 1, 1898, ch. 541, 30 Stat. 544 (1898), as amended (repealed October 1, 1979) (hereinafter "Act").

[4] Because the parties have briefed the relevant issues of statutory interpretation at length, *amici* will focus primarily upon the historical and policy basis for a clear absolute priority rule as codified in 11 U.S.C. § 1129(b).

legal rule of Section 1129(b)), and leads to transfers of reorganization value from creditors, where Congress has said it belongs, to existing owners. In short, the new value rule distorts priorities set by Congress, prolongs cases, and inevitably increases the cost of credit.

ARGUMENT

I. The Primary Pre-Code Use Of The New Value Rule Was To Deal With Dissenting Minority Creditors.

There is no new value rule in the Code, and it is not seriously argued that the rule should be recognized on its own merits. Instead, proponents argue that it was a settled doctrine under pre-Code law that should be read into the Code. In this Part, *amici* show that the historical underpinnings of the rule are dubious at best, and that the rule was not such a well-established feature of pre-Code law that it should be deemed incorporated into a new and radically different statutory scheme.

A. Development Of The Absolute Priority Rule.

In the late nineteenth and early twentieth centuries, spurred by the widespread failure of America's railroads, the focus of bankruptcy law began to change from liquidation to reorganization. What is now universally referred to as the "absolute priority rule" — *i.e.,* that a debtor's creditors must be paid in full before its owners may retain value — developed in the context of the first railroad reorganizations, which were accomplished through equity receiverships.

These early reorganizations often centered around "friendly foreclosure" arrangements between secured creditors and owners which had the effect of transferring the debtor's assets to a new entity (encumbered by all or some of the old secured debt), leaving unsecured creditors with nothing more than a shell from which to seek collection of the amounts owed them, and enabling owners to retain the assets and going concern value of the

reorganized enterprise.[5] The absolute priority rule developed in response to unsecured creditors' complaints that these early arrangements improperly eliminated their rights.[6]

The first step in the formulation of the absolute priority rule was to permit unsecured creditors to challenge these receivership transactions based on the distinction between a typical mortgagor/mortgagee foreclosure (which eliminates all inferior claims) and these "friendly" foreclosures (which eliminated junior creditors' rights but allowed owners to retain an interest after the foreclosure).[7] Then, courts turned to consider the exact scope of those rights. In the landmark case of *Northern Pac. Ry. v. Boyd,* 228 U.S. 482 (1913), this Court struck a balance among the desirability of continuing to operate a railroad, the need for funds to do so (recognizing owners as the most likely source of those funds), and the unsecured creditors' rights by articulating a standard which required a "fair offer" to unsecured creditors.

After *Boyd,* two competing definitions of "fair offer" were suggested: a rule of "absolute priority" which recognized state law claims and did not permit owners to participate in the reorganized debtor unless those claims were satisfied in full, and a rule of "relative priority" which permitted owners to participate if earnings met certain levels and relative priorities among classes were observed.[8] In 1933 and 1934 Congress entered the fray by adding Sections 77 and 77B to the Act. While Sections 77 and 77B were

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[5] *See* Markell, *Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations,* 44 Stan. L. Rev. 69, 78-80 (1991) (hereinafter "Markell"); Ayer, *Rethinking Absolute Priority After* Ahlers, 87 Mich. L. Rev. 963 (1989) (hereinafter "Ayer").

[6] *See, e.g., Louisville Trust Co. v. Louisville, New Albany & Chicago Ry.,* 174 U.S. 674, 689 (1899).

[7] *See, e.g., Louisville Trust Co.,* 174 U.S. at 683-84; *Chicago, R.I. & P.R.R. v. Howard,* 7 Wall. (74 U.S.) 392 (1868).

[8] *See* Markell at 82. *See also* 6A Collier on Bankruptcy, ¶ 11.06 (14th ed. 1978).

not identical,[9] they both required that plans be fair and equitable as to each creditor and that all classes of affected creditors accept the plan by the required class vote.

The conflict between the relative priority and the absolute priority "camps" finally reached this Court in *Case v. Los Angeles Lumber Prods. Co.,* 308 U.S. 106 (1939). In *Case,* this Court considered whether "fair and equitable" as used in Section 77B of the Act embodied the concept of relative or absolute priority. This Court ruled that both majority creditor consent and a determination that the plan was fair and equitable were required for confirmation. It then held that the statute's use of the term "fair and equitable" incorporated the absolute priority approach, and thereby effectively ended the absolute priority versus relative priority debate.

B. Dissenters' Power And The Use Of The New Value Rule.

Sections 77 and 77B of the Act provided unsecured creditors with the right to vote by class on reorganization plans and required that a reorganization plan be fair and equitable as to *each* creditor, thus permitting an outvoted class member to block confirmation of a plan by convincing the court that the plan was not fair and equitable. But because absolute priority had prevailed in *Case,* the new rule lacked the flexibility that had been present in equity receiverships. Given the need for capital, the available sources of such capital, and the leverage of dissenting creditors, and faced with a strict absolute priority requirement, the courts struggled to fashion a rule that would recognize "certain practical considerations,"[10] *Case,* 308 U.S. at 117, and allow confirmation

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[9] Section 77, providing for railroad reorganizations, was enacted in 1933 (Act of March 3, 1933, Ch. 204, § 77, 47 Stat. 1467, 1474 (1933)); Section 77B applied to other kinds of corporations and was enacted in 1934 (Act of June 7, 1934, Ch. 424,§ 77B, 48 Stat. 911, 912 (1934)).

[10] The problem was particularly acute for railroads, where significant public interests were at stake. *See, e.g., Louisville Trust Co.,*174 U.S. at 682; *Ecker v. Western Pac. R.R.,* 318 U.S. 448 (1943).

of plans without "requir[ing] the impossible." *Boyd*, 228 U.S. at 508. Perhaps recognizing the dilemma, in *Case*, this Court stated in *dicta* that owners could under some circumstances participate in a plan, but only "based on a contribution in money or money's worth, reasonably equivalent in view of all circumstances to the participation of the stockholder," and only if "it satisfactorily appears that full recognition has been given to the value of creditors' claims," 308 U.S. at 121, 122 — a test that was not met by the *Case* owners, whose proposed contributions were intangible.

Thus, this Court's first statement of the new value rule was in *dicta*, gave no guidance as to the actual conditions under which it might be applied, and did not discuss how the new value rule could coexist with the absolute priority rule. No subsequent pre-Code decisions of this Court upheld as fair and equitable a plan providing for owner participation where senior claims were not satisfied in full.[11] In fact, there appear to be no published decisions under the Act adopting the rationale set forth in the *Case dictum* to confirm a new value plan over the objection of a dissenting creditor.[12]

It is critical to note, however, that whatever new value rule may have existed after enactment of Sections 77 and 77B of the Act could never be used to confirm a plan over the objection of an entire *class* of creditors, since it was a concurrent requirement that all classes accept the plan by a two-thirds majority. Act §§ 77B(e)(i), 77B(f). Thus, the only purpose of a new value rule under the Act after enactment of Sections 77 and 77B of the Act was to permit, in certain obviously extraordinary, but undefined,

[11] *See Consolidated Rock Prods. Co. v. DuBois*, 312 U.S. 510 (1941); *Marine Harbor Properties, Inc. v. Manufacturer's Trust Co.*, 317 U.S. 78 (1942); *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R.R.*, 318 U.S. 523 (1943). The more often litigated issue was the choice between chapter X and chapter XI (which did not contain a rigorous absolute priority rule). *See, e.g., General Stores Corp. v. Shlensky*, 350 U.S. 462, 465-66 (1956).

[12] *See* Ayer at 1016. *See also* Klee, *Cram Down II*, 64 Am. Bankr. L.J. 229, 241 (1990).

circumstances, confirmation of a plan accepted by a two-thirds majority vote of each class of creditors, and to bind dissenters notwithstanding the absolute priority rule.[13]

II. The New Value Rule Is Inconsistent With The Statutory Scheme Of The Code.

Given the weak historical antecedents of the new value rule, the Court of Appeals' conclusion that it was an established pre-Code bankruptcy practice, which Congress did not indicate an intention to change, seems strained. Any lingering doubt is resolved by examining the provisions and structure of the Code itself, which clearly preclude recognition of a new value rule.

A. The Code Eliminates The "Holdout" Problem.

The Code's provisions for class voting and the application of the fair and equitable standard literally reversed the statutory scheme of the Act. Under the Act, any class vote rejecting the plan was outcome-determinative, while an affirmative class vote triggered application of the fair and equitable rule as to each creditor in the class. Conversely, under the Code, a class vote accepting the plan is outcome-determinative, and a class rejection triggers application of the fair and equitable requirement to the class as a whole.

The new value rule as applied under the Act was, in essence, a creditor protection for the majority against the minority, only invoked to override dissenters from an affirmative majority vote. Because of the way the Code's voting provisions work, the absolute priority rule no longer requires the "impossible": any plan that could have been confirmed under the Act, by using the new value rule to override the objections of outvoted minority creditors, would by definition be confirmable under the Code with

[13] *See, e.g., Mason v. Paradise Irr. Dist.*, 326 U.S. 536 (1946) (upheld confirmation of plan whereby "new value" was provided by a *creditor*). While the Ninth Circuit cited *Mason* in support of confirming a new value plan providing for owner participation, 2 F.3d 899 at 906, *Mason* in fact involved new value being provided by a bondholder, this Court having upheld the ICC's determination that there was no value to support owner participation.

no need for a new value rule and without reference to the fair and equitable standard. Thus, the Code eliminates the possibility that dissenters will have the power to stymie confirmation — which is exactly the problem solved by the new value rule. The complementary goals of giving effect to the wishes of the majority of creditors, and of having a mechanism to override dissenters, are met by the workings of the Code itself, and the new value rule is superfluous.

B. The New Value Rule Is Contrary To The Policies Underlying The Code.

The new value rule is not, however, merely a harmless holdover from pre-Code days. Importing the Act's new value rule into the radically different statutory scheme of the Code vitiates the underlying policies of the Code, creates results that are different from, and sometimes diametrically opposed to, the results obtained by using the new value rule under the Act, and skews the debtor-creditor balance struck by the provisions of the Code.

The provisions of chapter 11 of the Code represent Congress' choice of creditor decisionmaking over judicial supervision. At the time the Code was being crafted, the judicial supervision model was articulated in the proposal that courts be permitted to override creditors' objections to plans which were found to be fair and equitable, without more precise standards, Markell at 89, and in the Bankruptcy Commission's proposal to permit owners to retain value under conditions to be applied by the court.[14] The judicial supervision model can also be found in both chapters 12 and 13 of the Code, which dispense with any requirement that creditors approve plans under those chapters.

The Code minimizes the discretionary aspect of plan confirmation under chapter 11. Majority approval of a plan by a class is both necessary and sufficient for confirmation as to that class, without either the need for court involvement or the possibility that the court will override the majority's choice. Making creditor

[14] Bankruptcy Comm'n of the United States, 1 *Report of the Comm'n on the Bankruptcy Laws of the United States*, H. R. Doc. 137, 93d Cong., 1st Sess. 256 (1973) (hereinafter "Commission Report").

choice outcome-determinative in many situations, which in turn allows creditors to waive the benefits of the absolute priority rule, was one of the innovations of the Code,[15] and is entirely consistent with the goals served by the new value rule.

In the limited situations under the Code where the bankruptcy court may review creditors' choices with respect to plans of reorganization, as when the majority of creditors in a class rejects a plan and the plan proponents request confirmation notwithstanding such rejection, the statute sets forth clearly-stated and easily-applied rules for the court to follow. Thus, pursuant to Section 1129(b)(2)(B)(ii), there are two choices: full payment or no value to junior classes. The facts necessary for the court to make the required analysis are easily available and readily interpreted; moreover, it is easy to understand Congress' motivation in permitting the court to override the creditors' rejection of the plan if either of these requirements is met. Where full payment is offered, a rejecting vote is likely to be motivated by something other than economics; where full payment is not forthcoming but no junior class will receive value, creditors will effectively receive all available value and their state law rights and priorities are being preserved.

Allowing use of the new value rule to override the majority creditors' rejection of a plan is another matter entirely. First, the rule departs from the Code by expanding the circumstances in which the court can override the creditors' choice. Second, it does so using a factually difficult, nebulous test that bears no resemblance to the bright-line standards set forth in Section 1129(b)(2)(B)(ii). In effect, recognizing a new value rule under the Code strips creditors of the ability to choose their treatment and allows the judge to sell the equity of the reorganized enterprise to the existing owners, at a price determined by the owners — a situation reminiscent of the equity receivership transactions which resulted in the purchase of assets by existing owners for less than the debt encumbering them. The Code does not contemplate forced sales in analogous circumstances, at least not without

[15] *See* Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 Am. Bankr. L.J. 133, 143 (1979).

affording creditors the right to credit bid at the sale. *See, e.g.*, 11 U.S.C. §§ 363(k), 1111(b)(1)(B)(ii).

This Court has already made clear that the creditors', not the bankruptcy courts', choice governs. In *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 207 (1988), where farm debtors argued that creditors would be better off with a plan permitting the debtors to retain their interests in exchange for future work, this Court stated that:

> The Court of Appeals may well have believed that petitioners or other unsecured creditors would be better off if [the debtors'] plan was confirmed. But that determination is for the creditors to make in the manner specified by the Code. 11 U.S.C. § 1126(c). Here, the principal creditors entitled to vote in the class of unsecured creditors . . . objected to the proposed reorganization. This was their prerogative under the Code, and courts applying the Code must effectuate their decision.

Most importantly, however, use of the new value rule under the Code stands the original purpose of the rule on its head. Under the Act, since there was no power to override the vote of a dissenting class, the rule could only be used as a weapon by majority creditors against the minority; it was a creditor's right. Under the Code, the only possible use for the rule is as a weapon by owners against dissenting classes of creditors. Neither this Court nor any other court has recognized, approved of, or even adverted to, the use of the rule for such a purpose.

C. Application Of The New Value Rule Disrupts The Code's Careful Balancing Of Interests.

Chapter 11 of the Code represents a complex compromise among competing concerns: the rehabilitation of debtors, the rights of secured creditors, and the rights *inter se* of senior and junior creditors and owners. This compromise was designed to balance different parties' relative strengths in negotiating the plan and to identify parameters for that negotiation. Recognition of the new value rule undermines both the compromise and the legislation.

First, the separate provisions of chapters X and XI of the Act were combined to create chapter 11 of the Code, with a single standard for confirming plans.[16] The absolute priority rule, which existed under chapter X but not chapter XI,[17] is incorporated into the new standard, but can be modified by class vote. Owners cannot preserve their interests without paying creditors in full, which they could do under chapter XI; however, they can preserve their interests, regardless of whether creditors are fully paid, if a majority of creditors within each class approves. As a result, when plans are negotiated owners have to convince creditors that their proposed contribution justifies whatever interest they seek to retain. Recognition of the new value rule under the Code negates this result, because it gives owners a second audience; they can appeal to the court if they fail to convince creditors.

Second, chapter 11 allows debtors to remain in possession, which reconciles former chapter X and the Bankruptcy Commission's recommendation,[18] both of which provided for the appointment of trustees in every case, with former chapter XI, which left the debtor in possession. Under the Act, where an independent trustee was appointed in every significant chapter X case, recognition of a new value rule did not raise the issues of conflicts of interest, breach of duty and collusion. Under the Code, though, recognition of the rule does raise these issues, and vitiates the compromise.

Third, under chapter 11 debtors are afforded a limited period of time, which may be extended, in which they have the exclusive right to propose and confirm a plan of reorganization. This provision was enacted not in an effort to give the debtor a special ability to impose a new value plan over the objection of a

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[16] H.R. Rep. 595, 95th Cong., 1st Sess. 220-241 (1977) (hereinafter "House Report").

[17] The "fair and equitable" language was repealed in 1952 because chapter XI "compositions" contemplated continued equity participation in the reorganized business. *See generally* 9 Collier on Bankruptcy, ¶ 9.18 (14th ed. 1978).

[18] Commission Report at 240.

dissenting class of creditors, but in the hope that the debtor's draft plan would be a focal point for negotiations. House Report at 231-232. A new value rule is inconsistent with the Code's exclusivity provisions.

Fourth, Section 1129 carefully balances the rights of dissenters by permitting a class vote to override minority creditors, but specifying the treatment of dissenting classes. There is no new value rule or other equitable principle available to junior creditors vis-a-vis dissenting senior creditors. It seems anomalous, therefore, to give owners a unique, *de facto,* cramdown power over classes senior to them through application of the new value rule.

Fifth, recognition of the new value rule undermines rights which Congress gave real property lenders pursuant to Section 1111(b), which was a response to the bankruptcy court's decision in *Great W. Life Ins. Co. v. Pine Gate Assocs., Ltd.*, 2 B.C.D. 1478 (Bankr. N.D. Ga. 1977). *Pine Gate* permitted confirmation of a plan which paid a real estate lender the appraised value of its collateral and preserved the existing owners' interests. Congress enacted Section 1111(b) to ensure that undersecured real estate lenders, whether or not they would have a deficiency claim under state law, have a deficiency claim in chapter 11 which can be voted against a new value plan. *See In re Tampa Bay Assoc., Ltd.*, 864 F.2d 47 (CA5 1989). Recognition of a new value rule under the Code undermines this protection, and revives the result Congress sought to eradicate, by permitting confirmation of *Pine Gate*-type plans which reduce the secured creditor's claim to the appraised value of the property, make minimal distributions to unsecured creditors, and allow owners to retain their interests.

The new value rule distorts the dynamics of the central compromise that shaped chapter 11 of the Code. The rule negates unsecured creditors' principal protection under the Code: the assurance that if they are not to be paid in full, they will at least receive all the reorganization value there is to be had.

III. The Court Of Appeals' Policy Rationale Is Inconsistent With The Code, And The "Standards" For The New Value Rule Are Difficult To Apply.

The Court of Appeals failed to articulate exactly why there should be a new value rule and how the purported standards for its use should be applied. Neither failure is surprising: no discernible bankruptcy policy is served by a new value rule, and it is difficult to apply vague standards in a vacuum.

A. The Court Of Appeals' Policy Rationale Is Inconsistent With The Code.

As discussed above, the new value rule was originally justified by the need to preserve going concern value, the rigor of the absolute priority rule and the disproportionate power of minority dissenting creditors to disrupt the process. Perhaps recognizing that this rationale is inapplicable under the Code, the Court of Appeals suggested that the bankruptcy courts' overriding goal should be the rehabilitation of distressed businesses as going concerns; the court cited the difference between going concern and liquidation value, the importance of maintaining jobs and the need to minimize an adverse effect on the businesses of suppliers and customers and "the economy as a whole," 2 F.3d at 916. Implicit in this approach is that the bankruptcy court has significant discretion in achieving the goal of reorganization, and this premise is at the heart of the opinion below: "[p]roperly applied, the new value exception allows bankruptcy courts to fulfill their assigned role of balancing the interests of debtors, creditors, old owners, and the public, guided by the overriding goal of ensuring the success of the reorganization." 2 F.3d at 917.

Closer examination proves that the Ninth Circuit's policy rationale is ephemeral. First, it is difficult to relate to the typical post-Code cases implicating the rule — which involve single-asset real estate partnerships, farms and small corporations. Concerns about minimizing disruption of the economy do not apply in these cases, and job loss is unlikely in real estate, and at least some farm, cases. Moreover, in cases involving businesses large enough for the rationale to apply, the very nature of the new value rule virtually precludes its use. For debtors whose ownership is widely

or publicly held, participation by all owners is impracticable, and any plan which attempts to limit participation to some but not all owners raises issues of securities law requirements and fiduciary obligations. *Lebold v. Inland Steel Co.*, 125 F.2d 369 (CA7 1941), *cert. denied*, 316 U.S. 675 (1942); 12B *Fletcher Cyc. Corp.* § 5811 (Perm. Ed.).

More significantly, the Court of Appeals' rationale is one that Congress did not adopt. While there certainly are Congressional statements, and language in decisions of this Court, that describe a policy in favor of reorganization, those statements merely describe the provisions of chapter 11 of the Code.[19] They do not form the basis for some additional judicial power to confirm plans on policy grounds. Professors Blum and Kaplan cautioned against such an open-ended power as follows:

> The trouble with conferring this wide discretion on the reorganization judge is patent. A chief concern behind the adoption of the absolute priority doctrine was to prevent junior investors from gaining participation in a reorganized entity by trading on the nuisance value of otherwise worthless claims. Explicit authorization of judicial discretion would again legitimate and encourage that technique. A mass of experience reveals that courts have generally been prone to accept compromises in order to expedite termination of lengthy proceedings over complicated corporate financial matters and to avoid having to make and carry out hard decisions. Nothing suggests that this temptation will be less in the future.[20]

Notwithstanding that Congress was clearly aware that it had the option of articulating a policy favoring reorganization,[21] no

[19] *See, e.g., NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 527 (1984).

[20] Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. Chi. L. Rev. 651, 664 (1974) (hereinafter "Blum & Kaplan").

[21] In fact, Congress rejected a proposed amendment by the Bankruptcy Commission to liberalize the absolute priority rule to include continued management or other participation beyond money or money's worth. *Ahlers*, 485 U.S. at 205. At no time during the process of

such policy is reflected in the statute itself, which contains a number of alternatives to reorganization. Thus, Sections 1123(a)(5)(D) and 1141(d)(3) clearly contemplate plans which provide for the sale of all of the debtor's assets; Section 1112(b)(2) authorizes dismissal or conversion of the case if a plan cannot be effectuated; Section 1121(d) permits termination of exclusivity; and Section 1104 gives the court the power to appoint a trustee on discretionary grounds, which could include a debtor's inability to confirm a plan. Several of these provisions offer remedies for the parties' failure to agree; the one remedy conspicuously absent is the bankruptcy court's ability to override class votes on equitable or policy grounds.

Nor did Congress leave a vacuum on this point to be filled by the bankruptcy courts. As argued in Part II above, Congress left the choice between reorganization and liquidation of a chapter 11 debtor to its creditors, even though it certainly knew how to give the bankruptcy court power to override creditor dissent. Congress specifically did so in chapters 12 and 13 of the Code by making creditor consent irrelevant to the confirmability of plans; it did so in establishing the "adequate protection" concept for the use of cash collateral and allowing the bankruptcy court, not the affected creditor, to decide if adequate protection was being provided; and it did so in permitting plans to be confirmed over a secured creditor's rejecting vote based on a showing that the plan would provide the objecting creditor with the value of its interest in the debtor's property or the "indubitable equivalent" thereof. *See* 11 U.S.C. § § 361, 363, 1129(b)(2)(A)(iii). Section 1129(b) sets forth different standards for confirming a plan over creditor rejection with respect to secured and unsecured claims, giving the bankruptcy court greater discretion as to secured claims.

While arguments can be offered for giving the court broad equitable powers to confirm plans over creditor opposition and to "balance the interests of debtors, creditors, old owners, and the

enacting the Code did Congress articulate any preference for reorganization as a principle of substantive law which should be enforced by the bankruptcy courts.

public," this view of bankruptcy law simply is not part of the Code. This Court should not, by decision, insert it at this time.

B. The Courts' Difficulty In Applying The New Value Rule Demonstrates Its Infirmities.

In light of the absence of any bankruptcy rationale for the new value rule, courts have found it virtually impossible to apply and have failed to articulate consistent standards for its application. The Court of Appeals summarized the existing standards as follows: existing owners were required to "offer value that was 1) new, 2) substantial, 3) money or money's worth, 4) necessary for a successful reorganization and 5) reasonably equivalent to the value or interest received." 2 F.3d at 908.

Experience in applying these standards exposes numerous structural flaws in the new value rule. Courts applying the "substantiality" requirement have struggled with the question of how much is enough. Some courts have suggested that "substantiality" is not a separate requirement at all, whereas others posit that there must be some proportionality between the new value and the amount of unsecured debt to be discharged.[22] Likewise, courts have struggled with various innovative forms of "money's worth" such as guaranties, payment of expenses, forgiveness of existing debt and contributions of property to be used in the reorganized business.[23]

The "necessary" component has caused even more interpretive problems. Some courts do not apply this requirement at all.[24] Others, such as the Court of Appeals here, have adopted a tautological approach — *i.e.*, if the new value is contributed and

[22] *Compare In re Yasparro*, 100 B.R. 91, 97 (Bankr. M.D. Fla. 1989), *with In re Snyder*, 967 F.2d 1126 (CA7 1992).

[23] *Compare In re Potter Material Serv., Inc.* 781 F.2d 99, 103 (CA7 1986) (renewal of shareholders' guaranty held to be new value, even though existing guaranty arguably unaffected by bankruptcy), *with Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1362 (CA7 1990) (shareholders' guaranty did not constitute new value). *See also Ahlers*, 485 U.S. at 203 (labor and expertise not new value).

[24] *See, e.g., In re Henke*, 90 B.R. 451 (Bankr. D. Mont. 1988).

the negative vote of a dissenting class can be ignored as a result, thus allowing confirmation, the new value is necessary. Still other courts reason that new capital is needed for the continued operation of the business and imply that having cash is always helpful.[25] Some courts state that new funds are necessary to pay current obligations under the plan, and others say that if such funds are so used they are not necessary.[26] Finally, some courts simply suggest that no sensible outsider would invest the necessary funds.[27]

Many owners suggest that their contributions are "necessary" to cash out unsecured claims (usually at a few cents on the dollar). This creates a structural problem: the Code does not give owners the power to cash out unsecured claims over their holders' objection and retain the upside. If creditors do not accept a proffered cashout, Section 1129(b) makes them owners. Section 363(k) permits secured creditors to "credit bid," and courts have interpreted this requirement to be applicable to sales under a plan.[28] By the same reasoning, unsecured creditors can accept or reject an offer of partial payment. Permitting owners to force creditors to accept a lesser cash return undercuts the essence of

[25] *In re Mortgage Inv. Co. of El Paso*, 111 B.R. 604, 620 (Bankr. W.D. Tex. 1990) (must be a showing that capital infusion is necessary for the continued operation of the debtor).

[26] *Compare In re Montgomery Court Apartments*, 141 B.R. 324, 345 (Bankr. S.D. Ohio 1992) (contribution necessary to establish a reserve and pay obligations under the plan), *with In re Sovereign Group, 1985-27, Ltd.*, 142 B.R. 702, 708 (E.D. Pa. 1992) (infusion of new capital to pay creditors not necessary to continued operations of debtor).

[27] *In re Aztec Co.*, 107 B.R. 585, 588 (Bankr. M.D. Tenn. 1989).

[28] *See In re California Hancock, Inc.*, 88 B.R. 226 (Bankr. CA9 1988). Some have proposed, to solve problems with the new value rule, that unsecured creditors be permitted to credit bid in the new value context. *See, e.g.*, Markell at 121-23. However, there are practical problems in trying to conduct an auction when one bidder is a class consisting of many creditors. Such procedure is also likely to be inefficient, costly and time-consuming.

the rule set forth in Section 1129(b), which requires full payment or affirmative class vote. There is no "third choice."

The meaning of the requirement regarding the value of the interest to be retained by existing owners is also uncertain. Some courts require detailed analysis of cash flow and revenues, the value of control, and the value of tax benefits, while other courts permit the test to be satisfied by showing the debtor's history of losses and poor prospects. *See In re U.S. Truck Co.*, 800 F.2d 581, 588 (CA6 1986).

As the courts struggling to apply the new value rule have found, these purported underlying requirements are inherently uncertain, and are only made more so when there is no Congressional policy to serve as a lodestar for the bankruptcy court's analysis.

IV. The New Value Rule Delays Resolution, Distorts Priorities, Increases the Costs of Reorganization, And Makes Credit More Expensive And More Scarce.

Policy concerns militate against recognition of a new value rule: the rule muddies a clear distribution scheme, increases lenders' costs, and taints the lending process.

A. The Code Adopts Specific Distribution Rules Which Allocate Ownership Of Insolvent Entities To Their Creditors.

A reorganization case usually arises from a business, not a legal, problem. The basic issue in a reorganization case is how to allocate "reorganization value" among creditors whose claims have been reduced, restructured or eliminated in accordance with the distribution rules set forth in the Code. Both the process selected for allocating reorganization value and the nature of the rules to be applied within that process are important to creditors because they affect the timing and amount of creditors' recoveries. This is particularly true in the bankruptcy arena, as most

debtors are insolvent,[30] which means that the costs of bankruptcy are largely borne by creditors.

The Code adopts a litigation mode, which is often inefficient, for allocating value.[31] The certainty and precision of the rules to be applied by the courts overseeing the litigation bear on the length of time it will take to resolve issues,[32] the cost of resolution and the pressure to compromise. Generally, therefore, creditors' economic interests are served by precise rules that are uniformly applied. Such definitive rules "set guidelines for carrying on negotiations, largely by validating or invalidating certain lines of argument and by fixing boundary marks upon the areas within which negotiation is allowable."[33] When entering into a credit relationship, lenders need such rules in order realistically to evaluate their positions and the risks and rewards of alternative courses of action.

Section 1129(b) is just such a definitive rule: reorganization value is to be distributed hierarchically from senior creditors to junior creditors to owners. Alterations are only allowed if the class adversely affected by the alterations approves. Thus, the Code leaves it to creditors' self-interest to alter priorities; no court has

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[30] *Amici* have examined each of the reported (Bankruptcy Reporter) post-*Ahlers* cases in the Courts of Appeals and the District Court, as set forth in the Appendix hereto. None involved any question of insolvency.

[31] Indeed, this inefficiency has led to a spirited debate over whether chapter 11 maximizes creditor recoveries, or whether some form of liquidation, quick sale, or other approach would be preferable. *See generally* LoPucki, *The Trouble With Chapter 11*, 1993 Wis. L. Rev. 729, 730-31 nn. 2-9 (reviewing secondary authorities) (hereinafter "LoPucki"). The choice of a litigation system to resolve bankruptcy is not universal; other countries call upon accountants or public officials to allocate value.

[32] Professor LoPucki has found that, on average, smaller cases take more than twice as long to reorganize under the Code than they did under the Act. *See* LoPucki at 745.

[33] Blum & Kaplan at 653.

the power to require classes to so act.[34] Another feature of Section 1129(b) is that creditors "own" an insolvent business.[35] This ownership includes the right to determine the disposition of both control of the business,[36] which is a key element of reorganization value, and the business itself. Applied by its terms, Section 1129(b) functions as a clear, fair distribution rule.

B. Recognition Of A New Value Rule Adversely And Unjustifiably Affects The Lending Process.

1. The Impact Of The New Value Rule.

Even though Section 1129(b) allocates to creditors the value of control over the debtor, the creditors' ability to realize on this value is sharply limited even without a new value rule. The debtor's control over the bankruptcy process, its control over access to information and ability to impose significant costs on others who seek such access, its centralized decisionmaking, its ability to use operating funds for legal and other bankruptcy expenses and to litigate with creditors over distribution issues, its exclusivity period for filing plans and courts' willingness readily to extend that period,[37] and its strong economic motives to maintain control and somehow create value for owners, severely affect

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[34] *See Kham & Nate's*, 908 F.2d at 1360.

[35] *Case*, 308 U.S. at 116; *Boyd*, 228 U.S. at 508. Corporate law recognizes that "when a corporation becomes insolvent, the fiduciary duty of directors shifts from the stockholders to the creditors." *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (CA4 1982), *cert. denied*, 461 U.S. 928 (1983).

[36] Many decisions recognize that control itself can be a corporate asset. *See, e.g., Perlman v. Feldman*, 219 F.2d 173 (CA2 1955).

[37] Many courts routinely extend exclusivity periods. In recognition of this problem, Congress recently considered legislation with a one year outside limit. S. 540, 103d Cong., 1st Sess. § 102 (1993). Some judges believe that chaos will ensue if competing plans are filed. *See generally In re Public Serv. Co.*, 88 B.R. 521 (Bankr. D.N.H. 1988) (extending exclusivity, but dismissing debtor's "chaos" argument); LoPucki at 754-56. One study found that in 34 of 43 cases of clearly insolvent debtors, exclusivity continued throughout the case; 27 of the 34 cases lasted for more than two years. LoPucki & Whitford, *Bargaining Over Equity's*

creditors' ability to realize on this element of reorganization value.[38]

Recognition of a new value rule significantly augments owners' ability to retain control of an insolvent debtor, and thereby further diminishes value accorded to creditors, in complete disregard of the Code's statutory scheme. Thus, application of the new value rule is unsatisfactory because it strips creditors of their Code-granted power to decide how reorganization value will be allocated, giving that power to the bankruptcy court instead;[39] the problem is compounded because the "standards" for applying the new value rule substitute judicial discretion and case-by-case analysis for the Code's very specific distribution rules.[40] The Court of Appeals' approach essentially leaves it to the bankruptcy

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Share in the Bankruptcy Reorganization of Large Publicly Held Companies, 139 U. Pa. L. Rev. 125, 128 & n.6 (1990).

[38] *See* LoPucki at 732-39. Indeed, these issues have led commentators to propose various auction procedures or preemptively to exclude insolvent debtors from the confirmation process. *See, e.g.*, Markell at 107-11, 114-16; Note, *The Bankruptcy Code and the New Value Doctrine: An Examination into History, Illusions, and the Need for Competitive Bidding*, 79 U. Va. L. Rev. 917, 948-56 (1993); LoPucki & Whitford, *Preemptive Cram Down*, 65 Am. Bankr. L.J. 625 (1991).

[39] *Kham & Nate's*, 908 F.2d at 1360 (the new value exception "means a power in the *judge* to 'sell' the stock to the managers even when the creditors believe that this transaction will *not* augment the value of the firm") (emphasis in original).

[40] *See In re Greystone III Joint Venture*, 995 F.2d 1274, 1284 (CA5 1991) (Jones, J. dissenting, observing that if courts "may implement 'new value' nonconsensual reorganizational plans governed by such amorphous standards, one wonders why Congress bothered to frame elaborate ground rules for achieving consensual plans."), *corrected, reinstated, reh'g denied*, 995 F.2d 1284 (CA5 1991), *cert. denied*, 113 S. Ct. 72 (1992). One effect of the Court of Appeals' decision below may be to immunize new value determinations from effective appellate scrutiny because of the difficulties in reviewing decisions balancing multiple factors which tend to be highly discretionary and subjective, and the failure to tie the factors to any verifiable bankruptcy policy.

court to work out the details, thereby encouraging fencing, bluffing, posturing, and all the attendant problems of litigation — all to resolve a basic issue which Congress already has decided. Ultimately, the procedure contemplated by the Court of Appeals would increase costs and delay resolution.

The problem is exacerbated in many cases where owners attempting to use the new value rule propose plans containing other mechanisms which undermine creditors' rights, such as classifying claims in such a way as to guarantee the necessary accepting class required by Section 1129(a)(10).[41] These various devices have often resulted in insolvent debtors proposing plans which are opposed by the creditors who have the overwhelming economic interest in the debtor, and which negate the protections accorded by Congress in Section 1129(b).

For creditors, the introduction of a new value rule lowers predictability, increases costs, and ultimately forces concessions to owners. Thus, the creditor confronted with a debtor's proposed new value plan must either oppose the plan and/or try to confirm a competing plan (which the owners will oppose). There is little downside or cost to the owners, since they are already "out of the money." By contrast, the creditor must fund not only the costs of its own litigation, but since the debtor is insolvent, the owners' costs in seeking to confirm their plan.[42] Bankruptcy expenses continue while the litigation goes on, and the creditor faces the real risk of an erosion of the value of the business and a concomitant decline in reorganization values.[43]

Given the vagaries of the new value rule, no lawyer can assure a creditor client of certain, or even probable, victory in the litigation. Even defeating the new value plan may be a Pyrrhic victory, in that reorganization value will have declined and the plan process must begin anew. Under these circumstances, even the hardiest creditor is inclined to eschew the fight and give up some value to owners.[44] This is, of course, precisely what is *not* supposed to happen under Section 1129(b) and the decisions of this Court applying the "fair and equitable" doctrine.

2. The Stated Rationales For The New Value Rule Are Specious.

None of the policies articulated by proponents of the new value rule overrides Congress' decision to structure reorganizations around creditor choice and to specify a distribution scheme for the creditors of insolvent debtors.

a. ***Auction.*** New value plans have been analogized to "auctions," at which the owners wind up as the high bidders.[45] In fact, a new value plan is the antithesis of an auction because neither creditors nor outsiders are permitted to bid.[46] Moreover, no reason has ever been offered for permitting the court to require an auction when the creditors do not choose to have one. The essence of Congress' choice to permit classes to vote against a plan, and to define what a rejecting class must receive for the plan to be confirmed notwithstanding such rejection, is the determination both to define the choice facing creditors and leave the choice up to creditors.[47]

b. ***Reorganization.*** A second attempted justification for a new value rule is that the debtor needs the owners' contribution to

[41] *Greystone*, 995 F.2d at 1277; *In re Bryson Properties XVIII*, 961 F.2d 496, 501 (CA4), *cert denied*, 113 S. Ct. 191 (1992).

[42] The owners' costs are usually included in the debtor's legal fees; owners rarely retain and compensate their own counsel.

[43] Business rarely improves in bankruptcy, once some initial stabilization takes place. Moreover, owners and managers of insolvent enterprises have "powerful economic incentives . . . toward reckless, high risk, short term investment policies." LoPucki at 732.

[44] Skeel, *The Uncertain State of an Unstated Rule: Bankruptcy's Contribution Rule After* Ahlers, 63 Am. Bankr. L. J. 221, 246-47 (1989).

[45] *E.g.*, Markell at 107-111.

[46] The Court of Appeals implied that the opportunity to provide new value need not be extended to creditors or third parties. 2 F.3d at 910-11.

[47] *Kham & Nate's*, 908 F.2d at 1360; *Greystone*, 995 F.2d at 1284. The bankruptcy court can always disallow votes cast in bad faith. *See* 11 U.S.C. §1126(e).

reorganize. This rationale fails as well: contrary to the Court of Appeals' opinion below, there is no reason to prefer a specific form of reorganization which permits owners to contribute funds and retain their ownership interests, or even to reorganize at all. If reorganization is the best economic alternative and new funds are required for continuing operations or capital expenditures, it should be possible to convince creditors to vote for a plan which either provides new value from owners in exchange for stock, or contemplates that creditors will put up the contributions themselves, or proposes a mechanism to raise the funds from a third party.

Presuming that reorganization using owners' funds is a preferred result, and that creditors opposing this result are merely being obstructionist, obscures the fact that disputes over new value are usually disputes over business issues such as the need for new money, the amount needed, the ability to obtain funds in other ways, the amount of equity a new contribution should buy, or even the wisdom of reorganization itself. The Code does not give bankruptcy courts the power to resolve such business issues in favor of reorganization, but has left them to resolution through negotiations over distribution of reorganization value under the plan. In the context of those negotiations, the Code gives creditors the choice between the best deal they can negotiate and the treatment they are entitled to under Section 1129(b). If negotiations fail, the court has no roving power to impose a solution on creditors or to require reorganization.

c. ***Access to Capital Markets.*** Yet another purported justification for recognition of a new value rule is that it enhances reorganizing debtors' access to the capital markets.[48] Yet as noted, most cases in which courts actually have applied the new value rule involve "single asset" real estate, farms or small, closely-held corporations. Although "access to the capital markets" has an appealing ring, it has little relevance to these cases, which do not involve attempts to sell a complex enterprise.[49]

[48] *See generally* Warren, *A Theory of Absolute Priority*, 1991 Survey of American Law 9, 14-16 (1991).

d. ***Creditor Plans.*** Finally, it has been argued that there is no harm in allowing debtors to take advantage of a new value rule, as creditors who disagree on the optimal shape of the reorganization can propose their own plan. Indeed, many commentators, and the influential National Bankruptcy Conference, believe that some assurance that creditors facing new value plans will be able to file their own plans is the solution to problems with the new value rule.[50]

This proposal has a number of flaws. First, creditors' ability to file their own plans is not a substitute for the certainty to which they are entitled under Section 1129(b). Second, proposing a competing plan merely exacerbates the litigation issues discussed earlier. Third, if both the creditor's plan and the debtor's plan are accepted, the bankruptcy court will have to choose one to confirm, and Section 1129(c), which governs the court's choice and requires the court to take into account creditors' and equity security holders' preferences, offers no guidance as to which plan should be approved in this situation.

Finally, preparing a creditor's plan is difficult for even the largest and best-financed creditors, given the lack of access to information and other practical and financial disincentives. Filing a creditor's plan is significantly more expensive than opposing a plan proposed by the debtor which does not comply with Section 1129(b), and there are many creditors who actively participate in cases and negotiate over plan treatment who cannot devote sufficient resources to prepare, file, and litigate creditor plans. Moreover, it is not an "either-or" proposition: a creditor proposing its own plan must still oppose the debtor's plan.

[49] Single asset real estate debtors usually have little or no going concern value.

[50] *See* ALI-ABA Conference, *Bankruptcy Reform Circa 1993, A Presentation of the National Bankruptcy Conference's Bankruptcy Code Review Project* 253-55 (1993); Note, *supra* note 38, at 947-51 & n.193 (citing authorities).

3. Summary.

The Court of Appeals' decision defies certainty and promotes litigation. Application of a new value rule delays resolution, allows owners which are often "out of the money" to prolong the process, and deprives creditors of their statutory choice between the best deal they can make with the debtor and their minimum entitlement under Section 1129(b), compelling them instead to choose between the costs of delay and the uncertainties of litigation, on the one hand, and the cost of buying peace, on the other hand. These practical concerns frequently compel settlements that result in a transfer of reorganization value to owners, and increase the overall cost of credit — an increase which must be passed on to all borrowers.

V. The Plain Meaning Principle Precludes Recognition Of A New Value Rule.

Adoption of the new value rule is precluded by the "plain meaning" principle, as articulated in this Court's recent decisions holding that pre-Code practice and legislative history are of only marginal relevance in interpreting the Code. In *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 240-242 (1989), this Court held that in the context of a comprehensive statutory scheme that comprises a substantial overhaul of prior law, the plain meaning of the statute should control unless a clearly unintended result would ensue. Although this Court has rendered a number of subsequent bankruptcy decisions, each — properly interpreted — reflects the standard set forth in *Ron Pair*.[51]

[51] *See, e.g., Patterson v. Shumate*, 112 S. Ct. 2242, 2247 (1992) ("plainly read, [Section 541(c)(2)] encompasses any relevant nonbankruptcy law, including federal law such as ERISA"); *Dewsnup v. Timm*, 112 S. Ct. 773 (1992) (pre-Code practice relevant only where provision at issue ambiguous); *Union Bank v. Wolas*, 112 S. Ct. 527, 531 (1991) ("[T]he fact that Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning"); *Toibb v. Radloff*, 111 S. Ct. 2197, 2200 (1991) (legislative history is irrelevant unless the statute is unclear); *Pennsylvania Public Welfare Dept. v. Davenport*, 495 U.S. 552, 563 (1990) (Court refused to resort to pre-Code practice where Congressional intent was clear from terms of statute).

A. Language Of Section 1129(b)(2).

Under Section 1129(b), a plan can be confirmed over a class' rejecting vote if various requirements are satisfied. A basic principle of Section 1129(b) is that the plan must be "fair and equitable" with respect to each dissenting impaired class. For a class of unsecured creditors, Section 1129(b)(2) requires the court to find that either they will be paid in full or that no junior claimant will receive any value under the plan "on account of" its claim, and does not provide any power to vary its provisions on equitable grounds or to recognize additional bases for cramdown. By contrast, other sections of the Code, such as Sections 361 and 552(b), specifically include equitable or value-based provisos and exceptions.

B. The Court Of Appeals Misread The "On Account Of" And "Includes" Language Of Section 1129.

The Court of Appeals below held that the plain language of Section 1129(b)(2)(B)(ii) — and in particular, the proviso "on account of" — was not inconsistent with recognition of a new value rule. The court reasoned that in a new value plan, owners are not receiving property under the plan "on account of" their prior ownership interests, but are receiving such property on account of their contribution of "new value." 2 F.3d at 908-11. This argument is flawed. Even the Court of Appeals recognized that "in some larger sense the reason that former owners receive new equity interests in reorganized ventures is that they are former owners." 2 F.3d at 909. In fact, what owners seek is the exclusive right to propose a new value plan, and the exclusive right to have such a plan confirmed over the objections of creditors. These exclusive rights are value received "on account of" the prior ownership interests, as is the ownership interest received under a new value plan.

The Court of Appeals attempted to avoid the conclusion that a new value plan inevitably gives owners an interest in property "on account of" their equity interests by constructing a distinction

between "direct or immediate causation" and "a more remote variety." 2 F.3d at 909. This distinction is completely unsupported by any of the statutory language or legislative history.[52]

The Court of Appeals also relied on the word "includes" in the prefatory language in subsection 1129(b)(2) as leaving room for judicial "legislation" of the new value rule. 2 F.3d at 912. This reasoning is directly contradicted by the *Ahlers* case, where this Court stated that "a reorganization plan in which [debtors] retain an equity interest in the farm is contrary to the absolute priority rule." 485 U.S. at 202. Although Section 102(3) provides that the word "includes" is not limiting, it should not be read to permit an exception directly contrary to a statutory rule.

C. The Court Of Appeals Misinterpreted *Dewsnup* And *Davenport* To Create A Rule Overly Deferential To Pre-Code Practice.

The Court of Appeals announced the following rule of statutory construction: "Once it has been shown that Congress was aware of a pre-Code practice, the remaining inquiry under *Dewsnup* and *Davenport* is whether it has made clear its intent to change that practice." 2 F.3d at 912. This "rule" is contrary to *Ron Pair* and its progeny, contrary to settled principles of statutory construction, and even contrary to the *Dewsnup* and *Davenport* decisions themselves, properly interpreted.

In *Dewsnup*, this Court used pre-Code practice as a guide to Congressional intent given manifest ambiguity in Section 506(d),

[52] In misinterpreting the "on account of" language, the Court of Appeals also misapplied the traditional principle of statutory construction that "a Court must give effect, if possible, to every clause and word of a statute," 2 F.3d at 908, and suggested that the "on account of" language would be "superfluous" if there were no new value rule. 2 F.3d at 909. This statement overlooks an obvious meaning for the "on account of such junior claim or interest" phrase. Without the phrase, an entity which happened to hold both a senior claim and a junior claim (or interest) would be barred from receiving any property under the plan, even though other holders of senior claims would receive property under the plan. The "on account of" language simply avoids the absurd result of penalizing the holder of a senior claim for also holding a junior claim.

which seems to permit a debtor to "strip down" liens to the value of the underlying property. This Court noted that such an interpretation directly contradicts the legislative history of Section 506(d), which states that such section permits liens to pass through the bankruptcy case unaffected. 112 S. Ct. at 779. Such an interpretation also contradicts the general structure of the Code for numerous reasons: (1) it operates as an avoiding power, although all other avoiding powers are specified in Subchapter III of the Code, (2) it overlaps and somewhat overrides carefully balanced provisions in Section 522, and chapters 11, 12, and 13 dealing with the treatment of undersecured claims (*i.e.*, claims exceeding the value of collateral), and (3) it conflicts with the redemption provision of Section 722. Unlike in *Dewsnup*, here there is no legislative history or statutory framework supporting the new value rule which is inconsistent with the provisions of Section 1129(b).

The Court of Appeals cited *Davenport* for the proposition that "[t]he Bankruptcy Code should not be read to abandon past bankruptcy practice absent a clear indication that Congress intended to do so." 2 F.3d at 912. In relying on this one passage taken out of context, however, the court ignored the holding in *Davenport*. In *Davenport*, this Court held that criminal restitution obligations are dischargeable debts under chapter 13, because they constitute "debts" under the plain language of Section 101(11). This Court refused to resort to pre-Code practice, concluding that Congressional intent was clear. This principle applies equally to the construction of Section 1129(b).

D. The Legislative History Shows That Congress Rejected The New Value Rule.

Even if Section 1129(b)(2)(B)(ii) is held to be "ambiguous," the legislative history shows that Congress did not intend to enact the new value rule into law. Congress explicitly adopted the absolute priority rule, and the legislative history of the statute supports an unqualified absolute priority rule.[53] Moreover, Con-

[53] House Report at 413 ("The general principle of the subsection permits confirmation notwithstanding non-acceptance by an impaired class if that class and all below it in priority are treated according to the

gress clearly was familiar with Chapter XI of the Act, which contained no absolute priority rule, and did not enact any such requirement in chapters 12 or 13.

Further, the Commission Report contained an express and detailed proposal for codifying the new value exception. Commission Report at 242. The court below, in a counterintuitive use of legislative history, used Congress' rejection of the proposal to support the new value rule. 2 F.3d at 912. The more natural interpretation of Congress' rejection of the proposal is that Congress rejected the new value rule.[54]

CONCLUSION

For the reasons stated herein, this Court should hold that Section 1129(b) does not embrace or incorporate a new value rule, and that a new value rule is inapplicable in chapter 11 cases under the Code.

Respectfully submitted,

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absolute priority rule. The dissenting class must be paid in full before any junior class may share under the plan.")

[54] The Commission's proposal was itself the subject of scholarly debate and was criticized as inconsistent with the absolute priority rule, thus weakening the "adoption by silence" argument. *See, e.g.*, Blum & Kaplan at 667-72.

THE APPENDIX INCLUDED HEREIN HAS BEEN REPRODUCED
AND SEPARATELY LODGED WITH THE CLERK OF THIS COURT

APPENDIX

Court of Appeals Cases Dealing with New Value Rule since *Ahlers*

Case	Type of Business	Alleged New Value	Court's Holding	Dispute over Debtor's Insolvency
Seattle Mortgage v. Boyd, 193 U.S. App. LEXIS 34459 (CA9 1993)	Individual farm	Promise of future payments	Promise did not constitute new value	No
In re Bonner Mall Partnership, 2 F.3d 899 (CA9 1993), *cert. granted*, 126 L. Ed. 2d 648 (1994)	Real estate limited partnership (single asset)	$200,000 cash and certain guarantees	New value rule survives. No decision on whether rule was satisfied	No
Unruh v. Rushville State Bank of Rushville, Missouri, 987 F.2d 1506 (CA10 1993)	Farm which was operated as a sole proprietorship	Exempt property, postpetition wages from independent employment, labor	Proposed contribution did not constitute new value	No
In re Snyder, 967 F.2d 1126 (CA7 1992)	Farm	$30,000 cash and release of lien on machinery	$30,000 was not substantial enough and a release of lien did not constitute new value	No
In re Bryson Properties, XVIII, 961 F.2d 496 (CA4 1992), *cert. denied*, 113 S.Ct. 191 (1992)	Real estate limited partnership (single asset)	Cash contribution of $625,000 which was to be used for asbestos clean-up and the continued operation of the partnership and a line of credit of $850,000, each of which was to be repaid from the proceeds of a sale of the real estate asset after payment of the secured claim	Even if there was some limited exception to the absolute priority rule, it was not satisfied here	No

Case	Type of Business	Alleged New Value	Court's Holding	Dispute over Debtor's Insolvency
In re Greystone III Joint Venture, 995 F.2d 1274 (CA5 1991), *corrected, reinstated, reh'g denied*, 995 F.2d 1284 (CA5 1991), *cert. denied*, 113 S. Ct. 72, (1992)	Real estate joint venture single asset)	$500,000 cash	Court's holding that there is no new value rule was withdrawn. Case decided on improper classification grounds	No
In re Anderson, 913 F.2d 530 (CA8 1990)	Farm	Unspecified amount of cash from unidentified relatives	This did not constitute new value	No
Kham & Nate's Shoes No. 2, Inc., v. First Bank of Whiting, 908 F.2d 1351 (CA7 1990), *reh'g denied, en banc*, 1990 U.S. App. LEXIS 18381 (CA7 1990)	Small Business (closely held)	Loan guaranty of $435,000	Guaranty did not constitute new value	No
In re Stegall, 865 F.2d 140 (CA7 1989)	Farm	Labor	Labor did not constitute new value	No

District Court Cases Dealing with New Value Rule since *Ahlers*

Case	Type of Business	Alleged New Value	Court's Holding	Dispute over Debtor's Insolvency
In re F.A.B. Industries, 147 B.R. 763 (C.D. Cal. 1992)	Real estate general partnership (single asset)	$2,000,000 cash. Unclear how cash was to be used.	There is a new value rule. No decision on whether rule was satisfied	No
In re Triple R Holdings, 145 B.R. 57 (N.D. Cal. 1991)	Real estate general partnership (single asset)	Cash payments from debtor (amount unspecified)	No new value rule	No
In re Sovereign Group, 1985-27, Ltd., 142 B.R. 374 (E.D. Pa. 1992)	Real estate limited partnership (single asset)	$135,000 in cash and a cashflow guaranty valued at $65,000	Guaranty does not constitute new value. $135,000 is not substantial enough	No
In re Tara Limited Partnership I, 1991 U.S. Dist. LEXIS 20144 (W.D. Wis. 1991)	Real estate (single asset)	Option of partners to contribute up to $100,000 each	Receipt of option without payment of value violated new value rule	No
Piedmont Associates v. Cigna Property Casualty Insurance Company, 132 B.R. 75 (N.D. Ga. 1991)	Real estate joint venture (single asset)	New partner to provide $841,000 for an 80% interest, existing partner to get a loan from new partner to acquire remaining 20%	Scheme amounted to sale of property which exceeded scope of new value rule	No
In re Lumber Exchange Limited Partnership, 143 B.R. 354 (D. Minn. 1991); *aff'd on other grounds*, 468 F.2d (CA8 1992)	Real estate limited partnership (single asset)	$800,000 ($200,000 to be paid to unsecured creditors and $600,000 to be used for changes and improvements)	Case dismissed as confirmation would result in confirmation of a plan for the benefit of 3% of claims and speculative interest of owners	No

Addendum 1

The New York State Bankers Association ("NYSBA") is the principal trade association for the commercial banking industry in New York State. Its 150 domestic and non-resident member banks collectively hold nearly $700 billion in assets and employ 170,000 persons in the State. The NYSBA's members, most of which are actively engaged in the business of making both secured and unsecured loans, include some of the largest banking organizations in the United States.

From time to time as appropriate the NYSBA appears as *amicus curiae* in cases that raise significant questions of law affecting the commercial banking industry and which have a direct, substantial and continuing impact on its members. This is such a case. This Court's determination of the issues presented in this appeal unquestionably will have a profound effect on the conduct of secured lending business by NYSBA member banks, both in New York State and elsewhere throughout the United States.